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AUTHOR Gold, Steven D.
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ABSTRACT

This paper examines the outlook for school finance over the next 5 years. The environment for increases in real school revenue per pupil during the rest of the 1990s will not be favorable. The rate of economic growth in the next 5 years will not be particularly robust, with capacity expected to increase only about 2.5 percent yearly. This relatively low growth rate reflects the slow increase expected in the labor force and a sluggish increase in productivity. The most significant problem for educational finance is likely to be reductions in federal aid to states. States will respond to decreases in federal aid for social and health programs by trimming increases in state education aid. Other negative factors will be continued strong competition for state tax dollars from corrections and health programs and conservative state tax policy. Legalized gambling is no panacea for hard-pressed state budgets, and property tax prospects are not improving. A dynamic economy will benefit schools in selected states, but the overall economic growth rate is likely to be moderate at best. Some states will shift reliance away from property taxes. Five revenue tables are included. (MLH)

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CONSORTIUM FOR POLICY RESEARCH IN EDUCATION

The Outlook for School Revenue in the Next Five Years

Steven D. Gold

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CONSORTIUM FOR POLICY RESEARCH IN EDUCATION

The Outlook for School Revenue in the Next Five Years

Steven D. Gold

May 1995

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Abstract

This paper examines the outlook for school finance over the next five years. The environment for increases in real school revenue per pupil in the rest of the 1990s will not be favorable. The most significant problem is likely to be reductions in federal aid to states. States will respond to decreases in federal aid for social and health programs by trimming increases in state education aid. Other negative factors will be continued strong competition for state tax dollars from corrections and health programs and conservative state tax policy. A dynamic economy will benefit schools in selected states, but the overall rate of economic growth is likely to be moderate at best. Although some states will shift reliance away from property taxes, most states will not do so.

Biography

Steven Gold is director of the Center for the Study of the States, which is part of the Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York. He is also a professor of Public Administration at SUNY-Albany. Prior to moving to Albany in 1990, he was Director of Fiscal Studies for the National Conference of State Legislatures. He has written or edited 17 books about state and local government finances, the latest of which is *The Fiscal Crisis of the States* (published in April 1995 by Georgetown University Press). He has testified before legislative committees or spoken at conferences in 47 states. He received a Ph.D. in economics from the University of Michigan.

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Introduction

Increases in elementary and secondary school spending have been meager so far in the 1990s. After large real increases in spending per pupil in each of the three previous decades, schools had little spending growth from 1990 to 1994.[1] Is this slowdown a temporary phenomenon, or does it mark a new pattern that will continue for the rest of the decade?

The answer to this question is fraught with uncertainty, but the outlook does not appear rosy as of the start of 1995. Key issues include:

- How fast will the economy grow?

- What direction will state fiscal policy take? Will states cut taxes sharply? How much will state school aid be hurt by competition from other programs, particularly Medicaid and corrections? Does gambling revenue offer much promise for taking the pressure off taxes?

- Is a property tax revolt brewing? Will many states follow in Michigan's footsteps in slashing property taxes, with replacement money coming from increased state aid? If so, what does that imply about revenue growth over time?

- What will happen to local school revenue? Will states steer local schools in the direction of increased reliance on local sales or income taxes?

- How will federal policy affect state finances? What would a balanced budget amendment (or federal aid reductions that could be enacted regardless of adoption of the amendment) portend for school finances?

[1] Real expenditure per pupil rose only 3.2 percent between the 1989-90 and 1993-94 school years. Allan Odden, "Including School Finance in Systemic Reform Strategies: A Commentary," *CPRE Finance Briefs* (May 1994).

Background

While this paper is primarily about the outlook for the next five years, it starts with a look backward, especially at trends in the 1980s and the first half of the 1990s, to provide a context for understanding likely future developments.

Real spending per pupil rose 69 percent in the 1960s, 22 percent in the 1970s, and 48 percent in the 1980s.[2] Although the period from 1960 to 1990 appears in retrospect to have been one of strongly rising school revenues, some important distinctions turn up under closer inspection. The dynamic growth in the 1960s was associated with enormous increases in state and local taxes, much of which occurred because of the cost of educating the baby boom generation. State and local tax revenue per $100 of personal income rose more than 20 percent from 1960 to 1971. This was associated with an upheaval in state tax structures, as 10 states adopted new personal income taxes and 9 states imposed new general sales taxes between 1960 and 1971. In a nutshell, this was a period of tremendous increases in school enrollment that were exceeded by increases in revenue.

The increase in school spending per pupil in the 1970s was much different. Enrollment peaked in 1973 and was lower at the end of the decade than at the beginning. Much of the growth of per pupil spending was due to lower enrollment rather than higher absolute spending.

The cessation of the pressure of enrollment increases had a marked effect on state and local taxes. In relation to personal income, revenue peaked in 1973, fell for a few years, and then approached but did not exceed the earlier peak in 1977 and 1978. (see Table 1, page 23) The most dramatic change in taxes during the 1970s did not affect their level but rather their composition, as states substituted their own taxes for the local property tax.

The last two years of the 1970s and first three of the 1980s were fiscally stressed times for schools, as their revenue was depressed first by the Tax Revolt and then by back-to-back recessions in 1980 and 1981-82. The tide turned in 1983, thanks to two events: publication of *A Nation at Risk* and a robust economic recovery. After being depressed for several years, state school aid rose sharply in fiscal years 1985, 1986, and 1987.

But 1987 was another turning point. The share of school revenue provided by state governments reached 49.8 percent in 1987 but has fallen every year since then, as Table 2 (page 24) shows. This caused a fiscal crunch at the local level because school enrollments were increasing again, in the 1990s at a rate of 1.6 percent or more per year.

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[2] Ibid.

The school property tax reversed its trend in the 1980s. After falling sharply from $2.02 to $1.36 per $100 of personal income between 1972 and 1982, it began to rise, reaching $1.50 per $100 of personal income in 1991 (the last year for which tax data are available). In other words, school property tax revenue relative to personal income was still much lower than in 1972, but it was considerably higher than in 1982.

The decrease in the state share of school spending was part of a general phenomenon dubbed "fend-for-yourself federalism." This phrase was coined by John Shannon in reference to federal policy toward state and local governments, but it also applied to state policy toward localities. In every year since 1985, local taxes have risen faster than state taxes. Property taxes for non-school governments have been rising just as fast as those levied by schools.

Growth Rate of the Economy

The rate of increase of personal income normally has a major impact on how fast school revenue grows. The National Center for Education Statistics uses this as one of the key variables in projecting school revenue, noting that between 1978-79 and 1990-91 spending grew at the same rate as disposable income.[3] Income trends also are the most important determinant explaining differences in growth rates of school spending among states.[4]

The conventional view is that the rate of economic growth in the next five years will not be particularly robust, with capacity expected to increase only about 2.5 percent per year. This relatively low growth rate reflects the slow increase expected in the labor force and the sluggish increase in productivity. By contrast, in the 1950s and 1960s the capacity of the economy grew more than 3 percent annually.[5]

Although personal income is expected to grow at a relatively modest rate, considerable variation will probably occur among states and regions. An important question is whether the states with the fastest income growth will also have above-average enrollment increases. The two do not always go together. For example, between 1984 and 1988 Connecticut had an exceptionally strong economy while school enrollment was not increasing, enabling it to provide very large increases in spending per pupil.

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[3] Debra E. Gerald and William J. Hussar, *Projections of Education Statistics to 2004* (Washington, DC: U. S. National Center for Education Statistics, 1993), p. 75.

[4] Therese McCarty, paper presented at 1994 APPAM conference.

[5] The conventional view could be too pessimistic because immigration could lead to stronger labor force growth and productivity increases may be accelerating. However, if the Federal Reserve subscribes to the conventional view and tailors monetary policy to keep long-term growth at no more than a 2.5 percent rate, that will produce the same result as if the conventional view were correct.

State Financial Trends

The most important influence on state fiscal conditions is the economy, but many other factors also affect state finances. The economy affects how much money states have available to spend, but support for schools also depends on state tax policy and other spending priorities, especially health and corrections. Many states have structural deficits, with the spending needed to maintain the existing level of services persistently tending to fall short of the revenue produced by their tax systems. In addition, even states without structural deficits may have fiscal crises that are self inflicted if they cut taxes without also reducing spending. These interwoven strands can be divided into three issues: tax policy, spending for programs other than education, and structural deficits. A final issue discussed in this section is whether legalized gambling could provide significant new revenue for schools.

State Tax Increases and Decreases

Table 3 (page 25) shows how much states raised or lowered taxes legislatively each year for the past three decades. Large differences are evident, with increases of close to 10 percent in some years and decreases as large as 2 percent in others. Four general patterns explain the fluctuations:

- The largest increases occurred between 1965 and 1971. No years since then have had increases of anywhere near the magnitude in those years. The main reason for those increases was the strain on state finances caused by the cost of educating the baby boom generation. After school enrollment peaked in 1973, increases never needed to be so large again.

- Larger increases tend to occur in odd-numbered years because most states elect governors and legislatures in even-numbered years. The electoral repercussions of raising taxes are less severe, the longer the time that elapses between the tax increase and the election.

- Large increases are concentrated during recessions and their immediate aftermath. Recessions often produce short-term fiscal crises, which are a favorable environment for increasing taxes. Tax increases are much more politically feasible at such times.

- Decreases tend to occur following recessions. In part, they represent the expiration of temporary increases. They also reflect the fact that if tax rates were raised a few years earlier it is often feasible to cut taxes without severe spending reductions. Recession-induced tax increases often result in revenue higher than needed to maintain the previous level of services after the recession ends. The policy choice then is either to cut taxes or to have a

permanently higher level of spending. The tax cuts in such instances are an "echo" of the earlier tax increases.

Developments in the 1990s are consistent with these patterns. Twenty-seven states raised taxes significantly in the 1990-93 period, where a significant increase is defined as one that increases total state tax revenue by 5 percent or more. In 1994, an election year, no states enacted significant tax increases and 21 states cut taxes, although most of the reductions were small (that is, 1 percent or less of total tax revenue). Not counting Michigan (which is discussed below), state taxes were cut $1.6 billion, which is less than 0.5 percent of total state tax revenue.[6]

Historical precedent suggests that 1995 will be another year of net tax cuts, simply because the economy has buoyed state tax revenue. Then the momentum for tax cuts should wane, and little tax activity would occur until the next recession.

But it is dangerous to assume that historical precedent will be followed. We may be, at least for a few years, in a new era, one with more tax cuts and fewer tax increases than would be expected by business as usual as we have known it.

The change is symbolized by four Republican governors who have been in office for at least a year—John Engler (Michigan), Fife Symington (Arizona), William Weld (Massachusetts), and Christine Todd Whitman (New Jersey)—and two newly-elected Governors—George Pataki (New York) and John Rowland (Connecticut). But while the anti-tax mood will have a negative effect on the level of taxation, its significance should not be blown out of proportion. Tax cuts are likely to be relatively moderate. The size of state government is unlikely to shrink much in real terms, although spending and revenue may fall somewhat as a proportion of national economic activity.

These predictions do not take account of the repercussions of changes in federal policy that may originate in the Republican Congress. If federal policy takes a radical turn that increases fiscal pressure on states, it could eventually override the anti-tax mood in the states.

Before 1994, Governors Engler and Weld had a reputation for cutting taxes that was far out of proportion to their actual record. After taking office in 1991, *neither cut taxes very much*. They did deserve their anti-tax reputation, however, because their *policies prevented tax increases*. Both of their states had severe fiscal crises, to which they responded by cutting spending and relying on fiscal gimmicks that postponed costs or shifted them to the federal government.[7] (In 1994, Michigan actually did cut taxes significantly, as discussed in a later section of this paper.)

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[6] Steven Gold, "State Tax Cuts: 1994 as Prelude to 1995," *State Fiscal Brief* 24 (January 1995).

[7] See chapters by Bruce Wallin and Robert Kleine discussing Massachusetts and Michigan in Steven D. Gold, ed., *The Fiscal Crisis of the States* (Washington, DC: Georgetown University Press, 1995).

Governor Whitman took their policies one step further by actually cutting the personal income tax significantly. After she took office in January 1994, New Jersey cut rates 5 percent retroactive to the start of the year and an additional 10 percent effective in 1995. In January 1995 she proposed an additional 15 percent cut for 1996, thus following through on her campaign proposal to cut the income tax by 30 percent.[8]

The sweeping Republican victories in November 1994 also imply that taxes will be lower than otherwise, but their significance is liable to be overstated. Tax policy was not a major issue in most of the 36 gubernatorial races.[9] Even though many of the incumbents running for reelection had increased taxes in 1991 or 1992, this did not appear to be a significant political liability in their campaigns.[10]

Four of the successful Republican candidates did make substantial income tax cuts a major issue. Two were incumbents (Branstad in Iowa and Symington in Arizona), and the other two were challengers (Pataki and Rowland). It is very doubtful they will be able to push through the full tax cuts they promised without politically unpopular spending reductions, but some tax cuts are likely, and this will adversely affect the pool of revenue available for increasing state school aid.[11]

The fact that there are now 30 rather than 20 Republican governors does not mean that large tax cuts are going to be ubiquitous. Large tax cuts in most states would seriously threaten maintenance of the existing level of services, and no governor has a mandate for that kind of change.[12] On the other hand, during the next fiscal crisis, whether it is precipitated by a recession or some other event, the examples of Engler and Weld could inspire many other governors to stand fast against tax increases.

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[8] Her reputation as a budget-cutter, however, is exaggerated. The budget that included the 10 percent cut relied heavily on gimmickry, postponing pension and health costs into later years. It is not a great feat to cut taxes by borrowing from the future.

[9] "Elections and State Policy," *State Policy Reports* vol. 12, issue 20 (October 1994), pp. 9-16.

[10] Steven D. Gold, "Scapegoating Taxes," *New York Times* (October 10, 1994); also, Steven D. Gold, "The Tax Record of Governors Running for Reelection," *State Tax Notes* (November 7, 1994), pp. 1358-59.

[11] Pataki proposed a 25 percent income tax reduction, while Rowland and Symington set the goal of totally repealing their states personal income taxes. Another governor with aggressive proposals to cut taxes and services is George Allen of Virginia. Even if large income tax reductions are implemented, they will probably be offset to some extent by increases in other taxes.

[12] In New York, for example, while most citizens favored income tax cuts, a majority opposed substantial spending cuts in any area. For many large programs (e.g., higher education, school aid, highways, and health care), most people were against any spending cuts at all. Harvy Lipman, "New Yorkers Want Cuts without Cuts," *Albany Times Union* (April 3, 1995), p. 1.

Changes in State and Local Tax Structures

The increase in state revenue for schools will come mainly from the personal and corporate income taxes and the general sales tax, which together account for more than 70 percent of state tax revenue. The increase in local revenue will come mainly from the property tax.

The revenue increases from these taxes will probably not be robust. Economists refer to a tax's elasticity as a measure of how much revenue increases in response to economic growth. The elasticity of each of the three major state taxes is lower than it was in the 1970s.

- The personal income tax is less elastic because of the trend toward flatter tax rates and the increasing proportion of personal income that is exempt from taxation (e.g., for employer-provided health insurance and pensions).

- The general sales tax is less elastic because of the growth of the service sector of the economy, which is taxed considerably more lightly than goods.

- The corporation income tax elasticity has fallen because of changes in tax laws, enhanced corporate efforts to minimize tax liability, and slow growth of profits.

- The elasticity of the property tax is lower because home values are increasing more slowly in response to a lower rate of formation of new households and perhaps also because of tax abatements for businesses.

The confluence of these trends along with spending pressures on state budgets led the leading national organizations of state governments to issue a report in early 1994 that warned of an "approaching crisis" unless states make major reforms in their tax systems.[13]

Spending for Other State Programs

Table 4 (page 26) presents the best available data on the rate of increase of each of the major categories of state spending since 1990. In constructing the table, an attempt was made to focus on how state tax dollars are used. This is important because for two programs (Medicaid and higher education) considerable substitution has been taking place, with regular tax revenue becoming less important. For example, tuition hikes compensate for state aid cuts in higher education.

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[13] Ronald Snell, ed., *Financing State Government in the 1990s* (Denver: National Conference of State Legislatures and National Governors' Association, 1993); for a discussion of the responsiveness of tax revenue to economic growth, see Steven D. Gold, "The Income Elasticity of State Tax Systems: New Evidence," paper presented at the October 1994 APPAM conference.

Elementary-secondary education stands in the middle of the priority line when it comes to dividing up state resources. Medicaid and corrections come before it, while higher education and welfare spending are behind it. Those have been the priorities for the past 15 years, and they are likely to continue in the latter part of this decade.

Each of the major programs warrants comment:

- Medicaid spending soared in the first several years of the 1990s, rising 17-19 percent annually. Its growth slowed sharply in 1994 for several reasons: lower health cost inflation, smaller increases in participation because of a stronger economy, and relatively little impact from new federal mandates to expand coverage. Even in 1993 and 1994, however, it grew at an 8 percent rate.[14] The Congressional Budget Office projects 10 percent increases for the rest of the decade. Even though that is much less than several years ago, it is nevertheless a substantial increase for a program that represents about 12 percent of general fund spending.[15]

- Corrections spending has risen because of the war on drugs and tougher sentencing laws. The national trend toward "three strikes and you're out" initiatives makes it certain that this spending will continue to grow at a high rate.

- Higher education fared worse than any other major part of the budget in the early 1990s, with state appropriations of tax money for operating expenses virtually unchanged between 1990 and 1993. Tuition rose sharply to compensate. Although higher education fared better in budget allocations for 1994 and 1995, its increases were still only about 3.3 and 4.1 percent per year, respectively.[16] The policy of relying on tuition more than appropriations to cover higher spending is likely to continue.

- Welfare spending was boosted by rising caseloads in the early 1990s, but it was not a first order problem for state budgets for two reasons: welfare is a small proportion of state budgets (Aid to Families with Dependent Children, the major welfare program, was only 2.8 percent of total state general fund spending in 1993), and few states raised benefits to reflect inflation.

- Aid for elementary-secondary education rose 7.1 percent in 1990-91, 3.2 percent in 1991-92, 3.9 percent in 1992-93, 1.1 percent in 1993-94, and 7.4 percent in 1994-95. In some

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[14] John Holahan et al., *Medicaid Expenditure and Beneficiary Trends, 1988-1993* (Washington, DC: Urban Institute, August 10, 1994).

[15] Some analysts, such as those at the National Association of State Budget Officers (NASBO), emphasize the share of Medicaid in total state spending, including that financed by federal aid and health care provider taxes. That proportion is considerably higher than 12 percent. A better measure of how Medicaid competes with other state programs is its share of general fund spending. The 12 percent figure was reported by NCSL for 1995.

[16] *Grapevine* (November-December 1994).

years a paradoxical situation existed: aid rose as a proportion of total state spending even though it fell as a proportion of total school revenue.[17]

Although this discussion has focused on national totals, it is interesting to note that on a state-by-state basis there is a difference between education and the other major programs. The trends for the other four kinds of spending are relatively uniform, with two doing well and the others faring poorly. But education's fate is more variable, depending on the setting of political priorities.

To summarize, aid for elementary-secondary schools faces considerable competition for state resources from Medicaid and corrections. Fortunately, Medicaid increases will be slower than they were in the early 1990s, but they will still be substantial. And as the country rebounds from the slowdown of the early 1990s, tax cutting and not education improvement have the policy spotlight.

Structural Deficits

The context for deciding how much to increase education aid depends on whether the state budget is structurally balanced, that is, whether the revenue from the tax system is sufficient to maintain the existing level of services. Some states have structurally balanced budgets, while others do not. The tax system and spending policies have major impacts on structural balance, but four other factors are beyond the control of states—the rate of economic growth, health cost inflation, demographic changes, and federal policies.[18]

Many states have been obscuring the existence of structural deficits by shifting costs to others: to the federal government, to local governments, to college students, and to future generations:

- To the federal government, by using creative financing to increase the federal share of Medicaid. Instead of paying for Medicaid solely with conventional taxes, most states turned to health care provider taxes, donations, and intergovernmental transfers to cover part of their Medicaid costs. These devices, most of which have belatedly been prohibited or restricted, were an important reason why federal aid to states rose sharply in the early 1990s.[19]

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[17] The annual growth rates are somewhat distorted by developments in California and Michigan. In two years, California shifted property tax funds from cities and counties to schools rather than increasing state aid. In 1995, Michigan increased school aid sharply to reduce property taxes.

[18] Steven D. Gold, "Is the State Fiscal Crisis Over?," in National Tax Association, *Proceedings of the 87th Annual Conference on Taxation: 1994*.

[19] Teresa Coughlin, *Medicaid Since 1980* (Washington, DC: Urban Institute, 1994).

- To future generations, through reduced pension contributions, borrowing, deferred capital spending and maintenance, etc.

- To college students, by increasing reliance on tuition as a source of funding for higher education. Between 1989-90 and 1992-93, state appropriations of tax dollars for higher education operating costs were virtually unchanged while tuition and required fees for undergraduates at public four-year institutions jumped 36.6 percent.

- To local governments, by cutting state aid or increasing it slowly, by increasing mandates, and by giving them more responsibility for programs.[20] As Table 2 showed, the state share of school revenue, for example, fell from 48.3 percent in 1989-90 to 45.7 percent in 1993-94.[21]

Legalized Gambling as a Revenue Source

The nation is in the midst of a casino craze. As of January 1995, 20 states had legal casinos in operation; in half of those states, they operate only on Indian reservations. The spread of casinos to more and more states appears inexorable, even though several proposals to authorize new locations were defeated in November 1994 referenda.

Gaming accounts for nearly half of Nevada's tax revenue, counting both the taxes paid by casinos and those paid by tourists who come for gambling vacations. It has also been a short-term bonanza for Mississippi, the state that has most benefited so far from the 1990s casino boom.

But gambling is no panacea for hard-pressed state budgets. Consider New Jersey, the state with the second largest casino industry until recently. Even though it has a dozen large, mature casinos in Atlantic City, the industry directly paid only $296 million in state taxes and license fees in 1991, only 2.5 percent of total state tax revenue. Including the sales and other taxes paid by tourists brought total casino-related revenue to less than 4 percent of total state tax revenue.[22]

Much of the public has a warped view of the fiscal significance of gambling. While the absolute number of tax dollars generated sounds large, it is relatively small in the total context of state revenue. For example, in 1992 the contribution of lotteries to state treasuries was less than 2.5 percent of state tax revenue.

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[20] Steven D. Gold and Sarah Ritchie, "State Policies Affecting Cities and Counties, 1990-93: De Facto Federalism," *Public Budgeting and Finance* (Summer 1994).

[21] Steven D. Gold and Deborah Ellwood, *Spending and Revenue for Children's Programs*, background paper prepared for conference sponsored by The Finance Project, October 1994.

[22] Steven D. Gold, "Gambling Is No Panacea for Ailing State Budgets," *State Fiscal Brief* 13 (October 1993).

As casinos proliferate, the fiscal benefits they provide to state coffers will shrink. The major tax benefit of gambling results from out-of-staters who make the casino a destination. If in-state residents are patrons, their wagering to a considerable extent comes at the expense of outlays for other kinds of gambling (like lotteries or parimutuel racing) or consumption which would produce sales and excise tax revenue. But increasingly casinos will be relying on a state's own residents because potential gamblers will have more gambling venues to chose among and because people prefer to travel shorter distances.

The point is not that casinos won't increase tax revenue by millions of dollars. They will. But much of this revenue will cannibalize other taxes, and it is partially offset by the cost of public services needed to service the casinos and their patrons (including the amelioration of social costs like increased crime and problems arising from compulsive gambling). From a fiscal point of view, a well-conceived casino industry will be a net benefit for a state, but not such a big one as to make a major difference in the overall fiscal situation.

Casinos and other gaming have spread rapidly in the first half of the 1990s, and they appear certain to continue to proliferate among states. While opposition based on the social problems caused by gambling and other considerations will impede this growth, it will eventually be overcome in many states. Opportunities to gamble legally will increase greatly in the years ahead, but that will not do much to help financially hard-pressed schools or other public services.

Property Tax Prospects

As mentioned above, property tax revenue rose faster than personal income from 1982 to 1992, both for schools and for other local governments. Michigan's school finance reform halted this steady increase in fiscal year 1995. How likely is Michigan's action to be replicated in other states?

The answer to that question is that numerous states will probably relieve property taxes although few if any will do so to the extent that Michigan did. The key to understanding property tax revolts is the concept of balance. If property tax burdens are unusually high, particularly if they are rising rapidly, a state is ripe for a property tax revolt.

There have been four successful statewide property tax revolts in the past two decades. They occurred in California in 1978 (Proposition 13), Massachusetts in 1980 (Proposition 2½), Oregon in 1990 (Proposition 5), and Michigan in 1994. In all four cases, property tax rates were unusually high. Elevated property taxes do not guarantee a revolt, but they make it much more likely. Consider what happened in these four states:

- In California, property taxes rose sharply in the mid-1970s at the same time that the state was accumulating an enormous budget surplus. The two developments were related. The school aid formula automatically reduced state aid as property assessments rose, saving the state money and increasing local property taxes. The tax increase was especially large for homeowners because the assessments of homes rose much faster than those of other properties, resulting in a shift of tax burdens to residential property. Proposition 13 cut property taxes to 1 percent of market value. Although no replacement revenue was provided, California was able to avoid a state tax increase until 1991.[23]

- Massachusetts in 1980 had the highest effective property tax rate in the nation, more than 3.5 percent. Proposition 2½ capped the property tax rate at 2.5 percent and limited revenue increases to 2.5 percent per year. Thanks to a booming state economy, Massachusetts was able to postpone a broad-based tax increase until 1989.

- Oregon property taxes rose sharply in the late 1980s. Property taxes reached an average rate of 2.5 percent of market value in 1990. After rejecting similar but more extreme proposals numerous times in earlier years, voters approved a measure that cut the top property tax rate to 1.5 percent, without providing replacement revenue. The state is still struggling with a financial crisis resulting from this measure, which has been phased in gradually since 1990.

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[23] Steven D. Gold, *Property Tax Relief* (Lexington: D.C. Heath, 1979).

- Michigan's property tax revenue per $100 of personal income was eighth highest in the country. At the same time its sales tax revenue per $100 of personal income was close to the lowest in any state that imposes a sales tax.[24]

In each of these four states, political leaders had allowed property taxes to become particularly onerous. The states also allow citizens to use the initiative process to change laws of which they disapprove, including changes in tax laws.

Fourteen states with relatively high property taxes that currently appear to have conditions that could provide fertile ground for property tax revolts include Arizona, Connecticut, Illinois, Iowa, Maine, Montana, Nebraska, New Hampshire, New Jersey, New York, Rhode Island, Texas, Vermont, and Wisconsin. As Table 5 (page 27) shows, these states all have relatively high property taxes, that is, property tax revenue exceeds 4 percent of personal income.[25] Agitation to reduce property taxes appears particularly strong in Nebraska, Vermont and Wisconsin. But governors in five other states—Arizona, Connecticut, Iowa, New Jersey, and New York—have made state income tax cuts their priority, seemingly foreclosing the possibility of reducing property taxes much. This leaves four states—Maine, New Hampshire, Rhode Island, and Texas. Prospects for significantly cutting property taxes do not appear good in any of these fiscally stressed states. New Hampshire and Texas would have to enact new broad-based taxes—in Texas, a personal income tax, and in New Hampshire, either an income or a sales tax. But that appears out of the question in the short run considering the positions taken by their political leadership.

Property tax cuts could also occur in states that do not have particularly high property taxes, such as Idaho and South Carolina, but they will probably be less common and not as large. Pressure for cuts is more likely if property tax burdens have been increasing significantly, as they have in Idaho and South Carolina.

There are four ways of reducing school property taxes: one is simply to reduce school spending. The other alternatives involve obtaining replacement revenue by raising state taxes, squeezing other parts of the state budget, or authorizing local nonproperty taxes. While some states may adopt each of these policies, the prospects are not good for widespread adoption of any of them.

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[24] For each state's property and sales tax levels in 1991, see Steven D. Gold, *Tax Options for States Needing More School Revenue* (Washington, DC: National Education Association, 1994), p. 44.

[25] Alaska, Kansas, Minnesota, Oregon and Wyoming also have property tax revenue above that level according to Table 5, but special factors are involved in each state. Oregon property taxes are being cut as a result of its 1990 initiative. Most of the property taxes in Alaska and Wyoming are paid by oil and/or coal companies. Kansas subsequently reduced reliance on property taxes, and Minnesota's data do not consider its circuit-breaker or the fact that homeowner taxes are much lower than business taxes because of its classified assessment system.

- Reducing school spending cannot result in a big immediate cut in property taxes because it is not feasible to reduce spending sharply all at once. Over time, however, a slower increase in school spending can result in a corresponding decrease in the rate of increase of property taxes.

- Raising state taxes to reduce property taxes has not been a frequent occurrence in the 1980s or 1990s, although it happened in Nebraska in 1990, in Kansas in 1992, and in Michigan in 1994. It is not popular because it merely redistributes tax burdens; it is a hard sell because it usually reduces the proportion of taxes that are paid initially by businesses, making tax burdens more explicit rather than hidden.[26] Michigan voters had often rejected proposals to raise sales taxes to cut school property taxes. The March 1994 vote was not framed that way: it involved choosing between two ways of cutting property taxes, one relying mainly on the income tax and the other on the sales tax. Voters did not have the choice of retaining the property tax.

- Squeezing other kinds of state spending has limited potential because of pressures to raise Medicaid and corrections spending. If those two programs are claiming a growing share of resources, it is difficult to obtain large increases for elementary-secondary schools unless total revenue is growing unusually sharply.

- Local sales and income taxes are particularly unsuited to states where school districts are highly fragmented. These nonproperty taxes can be used to supplement school revenue to a limited extent, but if they were to be the major source of local school revenue, large tax rate differentials would develop. Such differentials are more problematic with sales and income taxes than with the property tax because property is considerably less mobile.

Thus, because of problems raised by the alternatives, the property tax will probably continue to play a major role in funding schools. But will public discontent result in many more property tax revolts? That could occur if states pursue policies resulting in rapid increases in property tax burdens, such as continually reducing the state share of school revenue while school spending increases steadily. State officials can prevent large property tax increases by avoiding large cutbacks in state aid and/or by restricting the growth of local school spending through state controls. In any case, by carefully monitoring property tax trends, state officials can be aware of the risk of large increases before they occur and can adopt policies to prevent them.

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[26] The business share of the property tax base is normally considerably higher than its share of the income or sales tax bases. In this context, the income tax refers to the revenue from the personal and corporation income taxes.

Federal Initiatives

We could be on the brink of major changes in the federal government's roles in the economy and as a provider of aid to state and local governments. A balanced budget amendment fell only one vote short of approval in the Senate in 1995, and it appears likely to be approved by Congress by 1997. There is a strong possibility that such an amendment would be ratified by three-fourths of the states.

If ratified, the amendment is certain to result in a large reduction of federal aid to state and local governments. A likely scenario is that Social Security and defense spending would not be cut much, and taxes would not be increased much. Interest payments on the federal debt would also have to be exempt from cuts. If, as the Congressional Budget Office projects, the deficit is $319 billion in 2002, the year the amendment is expected to take effect, spending would have to be cut by 15 percent across-the-board to balance the budget. But if Social Security, defense, and interest payment are exempt, and the tax cuts that are part of the Contract with America are adopted, the cut would be at least 29 percent in discretionary federal spending, including aid to state and local governments. In 1995, when federal aid is approximately $231 billion, such a cut would reduce aid to state and local governments by about $67 billion. This estimate does not take into account that some high priority discretionary programs, like prisons, embassies, courts, tax enforcement, and protecting the borders would probably be cut less than average. To the extent such programs are protected, spending would have to be cut even more.[27]

Federal education aid would probably be a prominent victim of the cutbacks required to balance the budget, but the federal government provides only about 7 percent of the funding for elementary and secondary schools. The main risk for those schools is not direct cuts in federal aid but rather the repercussions of cutbacks in other federal aid programs. States would probably respond to cutbacks in federal aid for health and social service programs by reducing the share of their resources devoted to school aid.

This decrease in state aid for schools would continue the fiscal decentralization trend already in effect, with the state share of school costs falling from their current 45.7 percent level and property taxes increasing.

Although a balanced budget amendment would not take effect until at least 2002, it would begin to affect federal policy much sooner. In this respect, the spending reductions resulting from the Republican Contract with America could be seen as the first installment of unprecedented cutbacks in federal spending that will continue as the federal budget moves toward compliance with the balanced budget amendment. However, the spending cutbacks

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[27] Steven D. Gold, "The Impact of New Federal Policies on State Governments," *State Fiscal Brief* 26 (January 1995).

resulting from the Contract will not help to balance the budget because they will be matched by tax cuts. In fact, they will make it considerably more difficult to balance the budget because they have been designed so that their cost during the first five years is much less than after that period.[28] Of course, it is likely that the tax cuts in the Contract will not actually be enacted as proposed because the Senate and President have different views of how taxes should be reduced.

[28] This is because federal budget rules require that tax cuts be matched by spending reductions over five years, with no consideration of what may occur after that period. The U. S. Treasury Department estimates that the cost of the tax cuts in the Contract would grow from $190 billion in the first five years to $515 billion in the second five years after they took effect.

Conclusion

- The outlook for school revenue is for slow or moderate growth in the near future. If education is to improve in the coming years, it will primarily be because of implementation of reforms in how resources are used rather than because funding is sharply increased.

School revenue trends will differ from state to state for several reasons. First, some states will follow in Michigan's footsteps by providing significant property tax relief, but most states will probably not go in that direction. Second, states with relatively strong economic growth will be more able to increase revenue for schools than those with slower growing economies. Third, some states will probably give away a significant share of their revenue growth through sizeable tax cuts, although most will not. Finally, the impact of federal aid reductions will be uneven. It is very difficult to speculate, however, about which states will be hardest hit. If a balanced budget amendment is enacted, even the states with the smallest reductions will lose so much aid that it will have a significant adverse effect on schools.

Table 1
State and Local Tax Revenue Per $100 of Personal Income, 1970 to 1992

Fiscal Year	Total	Local	State	State				
				General Sales	Personal Income	Corporation Income	Severance	Other
1992	$11.54	$4.72	$6.84	$2.24	$2.18	$0.45	$0.10	$1.87
1991	11.30	4.62	6.70	2.23	2.14	0.44	0.12	1.77
1990	11.47	4.59	6.90	2.29	2.21	0.50	0.11	1.79
1989	11.55	4.55	7.02	2.31	2.20	0.59	0.10	1.83
1988	11.60	4.57	7.05	2.32	2.13	0.58	0.12	1.85
1987	11.48	4.48	7.02	2.26	2.16	0.59	0.12	1.89
1986	11.24	4.37	6.89	2.26	2.04	0.55	0.19	1.85
1985	11.28	4.34	6.97	2.25	2.06	0.57	0.23	1.86
1984	11.30	4.35	6.96	2.21	2.09	0.55	0.26	1.85
1983	10.68	4.25	6.46	2.02	1.88	0.50	0.28	1.78
1982	10.59	4.12	6.49	2.01	1.82	0.56	0.31	1.79
1981	10.85	4.20	6.67	2.07	1.82	0.63	0.28	1.87
1980	11.02	4.26	6.79	2.14	1.84	0.66	0.21	1.90
1979	11.37	4.46	6.94	2.19	1.81	0.67	0.16	2.11
1978	12.08	5.01	7.10	2.21	1.82	0.67	0.16	2.22
1977	12.15	5.17	7.02	2.14	1.77	0.64	0.15	2.32
1976	11.98	5.17	6.85	2.10	1.65	0.56	0.16	2.38
1975	11.74	5.09	6.68	2.07	1.57	0.55	0.15	2.34
1974	11.93	5.16	6.81	2.07	1.57	0.55	0.11	2.51
1973	12.41	5.43	7.01	2.04	1.60	0.56	0.09	2.72
1972	12.24	5.51	6.77	1.99	1.47	0.50	0.09	2.72
1971	11.50	5.26	6.27	1.88	1.24	0.42	0.09	2.64
1970	11.32	5.07	6.29	1.86	1.20	0.49	0.09	2.65

Note: Revenue for each fiscal year is divided by personal income in the calendar year that ended during it. State and local taxes do not equal total tax revenue because personal income for the District of Columbia is included in calculating total and local tax revenue per $100 of personal income but not in calculations for state taxes.

Sources: For tax revenue, U.S. Census Bureau, *Governmental Finances* (Washington, DC: U. S. Government Printing Office, various years). For personal income, unpublished data from the U. S. Department of Commerce with revised estimates as of September 2, 1992.

Table 2
Composition of School Revenue, 1977-78 to 1993-94

School Year	Federal	State	Local
1977-78	8.8%	44.3%	46.9%
1978-79	8.8	47.3	43.9
1979-80	9.2	49.1	41.7
1980-81	8.7	48.2	43.1
1981-82	7.4	47.9	44.7
1982-83	7.2	47.7	45.1
1983-84	7.0	47.8	45.2
1984-85	6.8	49.0	44.2
1985-86	6.7	49.4	43.9
1986-87	6.4	49.8	43.8
1987-88	6.4	49.3	44.3
1988-89	6.4	48.5	45.1
1989-90	6.3	48.3	45.4
1990-91	6.3	48.2	45.5
1991-92	6.7	47.5	45.8
1992-93	6.9	46.8	46.3
1993-94	7.0	45.7	47.3

Note: The 1993-94 estimates are preliminary and may be subject to relatively large revisions.
Source: National Education Association, *Estimates of School Statistics*, 1993-94 and 1987-88 editions.

Table 3
Net Legislative State Tax Changes by Year of Enactment, 1964 to 1994

Calendar Year	Billions of Dollars	Percent of Annual Collections
1994	-$1.6	-0.5%
1993	1.2	0.4
1992	1.4	0.4
1991	14.4	4.8
1990	9.2	3.5
1989	3.5	1.3
1988	0.6	0.2
1987	4.5	1.9
1986	1.1	0.5
1985	-1.3	-0.6
1984	2.3	1.2
1983	8.3	4.8
1982	2.9	1.8
1981	3.8	2.5
1980	0.4	0.3
1979	-2.0	-1.6
1978	-2.3	-2.0
1977	0.2	0.5
1976	1.0	0.9
1975	1.6	2.0
1974	0.4	0.5
1973	0.5	0.7
1972	0.9	1.5
1971	5.0	9.7
1970	0.8	1.7
1969	4.0	9.5
1968	1.3	3.6
1967	2.5	7.8
1966	0.5	1.7
1965	1.3	5.0
1964	0.1	0.5

Note: The second column shows tax increases legislated during a calendar year as a proportion of total tax revenue during the fiscal year which ends during that calendar year. Tax increases do not include extension of temporary increases scheduled to expire or taxes on health care providers.

Source: Steven D. Gold, *Tax Increases Shriveled in 1993* (Center for the Study of the States), based on information from the Tax Foundation for years prior to 1984, and the National Conference of State Legislatures thereafter, with some modifications for years after 1988.

Table 4
State Spending Increases, 1991 to 1995

Category	1991	1992	1993	1994	1995
Total	4.5%	5.1%	3.3%	5.0%	4.9%
School aid	7.1	3.2	3.9	1.1	7.4*
Higher education	1.3	1.3	-0.7	3.3	4.1
Corrections	9.2	4.3	6.9	9.7	8.0
AFDC	9.0	9.8	4.9	2.4	2.1
Medicaid	16.9	19.6	10.2	11.4	8.4

* Reflects 72 percent increase in Michigan (which paid for part of a large property tax reduction). Median increase was 5.0 percent.

The shares of general fund appropriations in 1995 are: school aid, 29.9 percent; higher education, 11.7 percent; corrections, 5.3 percent; AFDC, 2.6 percent; and Medicaid, 12.0 percent. Other kinds of spending represented 38.5 percent.

Note: Estimates are drawn from a variety of sources that use inconsistent conceptual frameworks, but they provide the best available indicators of spending changes financed by conventional taxes. Total expenditures and those for AFDC, Medicaid and corrections are only from the general fund. Higher education spending is appropriations of tax dollars for operating expenses. School aid excludes federal aid but does include revenue from earmarked funds.

Figures for 1991 and 1992 are actual spending; 1993, estimated spending; 1994 and 1995, appropriations.

Sources:

Total: NASBO, *The Fiscal Survey of the States* (November 1994)

School aid: National Education Association, *1993-94 Estimates of School Statistics* (March 1994), updated with unpublished information

Higher education: Edward R. Hines, *The Grapevine* (Illinois State University) (November-December 1994).

Corrections: 1991-93: NASBO, *Expenditure Report* (1992 and 1993); 1994-1995, NCSL, *State Budget Actions* (1993 and 1994)

AFDC: 1991-93: NASBO, *Expenditure Report* (1992 and 1993); 1994-1995, NCSL, *State Budget Actions* (1993 and 1994)

Medicaid: 1991-93: NASBO, *Expenditure Report* (1992 and 1993); 1994-95, NCSL, *State Budget Actions* (1993 and 1994)

Table 5
State-Local Revenue from Major Taxes per $100 of Personal Income in 1992

	Personal Income Tax	Rank	Sales Tax	Rank	Property Tax	Rank	Total Taxes	Rank
United States	**$2.38**		**$2.70**		**$3.69**		**$11.48**	
New England	2.90		1.75		4.45		11.44	
Connecticut	2.19	31	2.46	33	4.62	11	11.80	16
Maine	2.76	16	2.68	25	4.74	10	12.42	8
Massachusetts	3.90	4	1.45	44	3.84	22	11.20	27
New Hampshire	0.15	42	0.00	47	6.46	1	10.07	45
Rhode Island	2.45	26	1.99	40	4.84	9	11.39	22
Vermont	2.68	17	1.55	43	5.39	3	12.89	7
Mid Atlantic	3.50		2.21		4.38		13.13	
Delaware	3.79	5	0.00	47	1.65	47	11.70	18
Maryland	3.92	3	1.44	45	2.94	35	10.49	39
New Jersey	2.13	32	2.11	38	5.15	5	11.90	13
New York	4.40	1	2.67	27	5.16	4	15.47	2
Pennsylvania	2.78	15	1.93	41	3.11	33	11.19	28
Great Lakes	2.55		2.33		4.07		11.21	
Illinois	1.93	37	2.31	35	4.15	16	10.78	34
Indiana	2.64	20	2.87	18	3.32	27	10.44	40
Michigan	2.07	33	2.09	39	5.11	7	11.70	17
Ohio	3.25	11	2.22	36	3.18	31	10.83	33
Wisconsin	3.54	8	2.49	32	4.62	12	13.06	4
Plains	2.51		2.63		3.52		11.12	
Iowa	2.97	14	2.20	37	4.19	15	11.94	12
Kansas	1.83	38	2.60	30	4.03	20	10.86	31
Minnesota	3.51	9	2.58	31	4.07	18	12.98	5
Missouri	2.21	30	2.79	22	2.23	41	9.26	49
Nebraska	2.27	29	2.69	24	4.07	19	11.27	26
North Dakota	1.21	41	2.76	23	3.42	26	11.32	25
South Dakota	0.00	44	3.28	13	3.76	23	9.62	47
Southeast	1.71		3.01		2.80		10.33	
Alabama	2.02	34	2.81	19	1.13	50	9.31	48
Arkansas	2.48	24	3.58	8	1.83	46	10.60	35
Florida	0.00	44	3.34	12	3.90	21	10.17	42
Georgia	2.64	19	3.05	15	3.13	32	10.58	36
Kentucky	3.58	7	2.38	34	1.94	44	11.49	20
Louisiana	1.36	39	4.27	4	1.85	45	11.07	29
Mississippi	1.28	40	3.45	10	2.73	37	10.10	44
North Carolina	3.16	12	2.62	29	2.25	40	10.93	30
South Carolina	2.56	22	2.68	26	2.95	34	10.36	41
Tennessee	0.11	43	4.05	6	2.14	42	9.05	50
Virginia	2.63	21	1.64	42	3.28	28	10.05	46
West Virginia	2.32	28	3.02	16	2.02	43	11.38	23
Southwest	0.66		3.61		3.79		11.11	
Arizona	1.98	35	4.05	5	4.11	17	12.34	9
New Mexico	1.94	36	5.20	3	1.50	49	12.34	10
Oklahoma	2.46	25	3.16	14	1.57	48	10.57	37
Texas	0.00	44	3.47	9	4.27	14	10.85	32

Table 5
State-Local Revenue from Major Taxes per $100 of Personal Income in 1992

	Personal Income Tax	Rank	Sales Tax	Rank	Property Tax	Rank	Total Taxes	Rank
Rocky Mountain	2.50		2.70		3.60		11.17	
Colorado	2.42	27	2.80	20	3.51	24	10.54	38
Idaho	3.25	10	2.67	28	2.89	36	11.53	19
Montana	2.52	23	0.00	47	4.56	13	11.41	21
Utah	3.00	13	3.75	7	3.21	30	11.83	14
Wyoming	0.00	44	2.80	21	5.50	2	12.96	6
Far West	2.37		3.14		3.35		11.58	
Alaska	0.00	44	0.62	46	5.12	6	18.36	1
California	2.68	18	2.95	17	3.25	29	11.35	24
Hawaii	3.70	6	5.28	2	2.27	39	13.82	3
Nevada	0.00	44	3.36	11	2.44	38	10.14	43
Oregon	4.28	2	0.00	47	4.95	8	12.00	11
Washington	0.00	44	5.69	1	3.46	25	11.81	15

Center for the Study of the States, based on data from the U. S. Dept. of Commerce, Bureau of the Census.